

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF WASHINGTON

No. CV-04-25-FVS

In re METROPOLITAN SECURITIES
LITIGATION

AMENDED ORDER DENYING
CROSS MOTIONS FOR SUMMARY
JUDGMENT WITH RESPECT TO
NEGATIVE CAUSATION

THIS ORDER modifies the following sections of court record number 922: page 10, line 3; page, 13, lines 11 and 12; page 14, lines 1 and 7.

BACKGROUND

The plaintiffs purchased securities that were issued by Metropolitan Mortgage & Securities Co., Inc., ("Met"), and Summit Securities, Inc. ("Summit"). Met and Summit issued the securities pursuant to four registration statements. Each registration statement incorporated a financial statement. The companies' respective financial statements for Fiscal Year ("FY") 2000 were audited by PricewaterhouseCoopers ("PwC"). Their respective financial statements for FY 2001 were audited by Ernst & Young ("E&Y").

The plaintiffs have hired Harris L. Devor to review PwC's and E&Y's work. In his opinion, they committed a number of errors. For one thing, they allegedly allowed Met and Summit to overstate their

1 stockholders' equity in their FY 2000 and FY 2001 financial
2 statements. (Rule 26 Statement of Harris L. Devor at 11-15.) For
3 another thing, PwC and E&Y allegedly did not challenge Met's and
4 Summit's failure to maintain internal controls that, according to Mr.
5 Devor, were necessary in order to substantiate the value of their
6 assets. *Id.* at 112-16. Finally, PwC and E&Y allegedly did not
7 challenge Met's and Summit's practice of accruing interest on loans
8 that had been delinquent for 90 or more days. *Id.* at 117. Taken
9 together, say the plaintiffs, PwC's and E&Y's errors permitted Met and
10 Summit to falsely present themselves as healthy companies when, in
11 fact, they were desperately ill.

12 During the Summer and Fall of 2003, the value of the plaintiffs'
13 securities collapsed. The plaintiffs filed suit on January 20, 2004.
14 They seek relief pursuant to § 11 of the Securities Act of 1933. 15
15 U.S.C. § 77k. Section 11 "creates a private remedy for any purchaser
16 of a security if 'any part of the registration statement, when such
17 part became effective, contained an untrue statement of a material
18 fact or omitted to state a material fact required to be stated therein
19 or necessary to make the statements therein not misleading.'" *In re*
20 *Daou Systems, Inc.*, 411 F.3d 1006, 1027 (9th Cir.2005) (quoting 15
21 U.S.C. § 77k(a)). "Liability against the issuer of a security is
22 virtually absolute, even for innocent misstatements." *Herman &*
23 *MacLean v. Huddleston*, 459 U.S. 375, 382, 103 S.Ct. 683, 74 L.Ed.2d
24 548 (1983). An accountant's potential liability under § 11 is not as
25 broad. *Id.* at 381 n.11, 103 S.Ct. 683 (citing 15 U.S.C. § 77k(a)(4)).
26

1 "Section 11 of the 1933 Act permits an action against an accountant
2 based on material misstatements or omissions in a registration
3 statement, but only as to those portions of the statement that purport
4 to have been prepared or certified by the accountant." *Monroe v.*
5 *Hughes*, 31 F.3d 772, 774 (9th Cir.1994).

6 The plaintiffs may recover damages from PwC and E&Y in the event
7 they prevail under § 11. The measure of damages is:

8 **the difference between the amount paid for the security** (not
9 exceeding the price at which the security was offered to the
10 public) **and (1) the value thereof as of the time such suit**
11 **was brought**, or (2) the price at which such security shall
12 have been disposed of in the market before suit, or (3) the
13 price at which such security shall have been disposed of
14 after suit but before judgment if such damages shall be less
15 than the damages representing the difference between the
16 amount paid for the security (not exceeding the price at
17 which the security was offered to the public) and the value
thereof as of the time such suit was brought[.]

15 U.S.C. § 77k(e) (emphasis added). However, § 11(e) creates an
affirmative defense:

18 **[I]f the defendant proves that any portion or all of such**
19 **damages represents other than the depreciation in value of**
20 **such security** resulting from such part of the registration
21 statement, with respect to which his liability is asserted,
22 not being true or omitting to state a material fact required
23 to be stated therein or necessary to make the statements
therein not misleading, **such portion of or all such damages**
24 **shall not be recoverable.**

25 15 U.S.C. § 77k(e) (emphasis added). Typically, courts refer to the
26 defendant's burden as that of proving "negative causation." *Akerman*
v. Oryx Commc'ns, Inc., 810 F.2d 336, 340 (2d Cir.1987). Proving

1 negative causation is a heavy, but not insurmountable, burden. *Id.* at
2 340-41. The parties have filed cross motions for summary judgment
3 with respect to negative causation.

4 **STANDARD**

5 Rule 56(c) provides in part, "[J]udgment . . . should be rendered
6 if the pleadings, the discovery and disclosure materials on file, and
7 any affidavits show that there is no genuine issue as to any material
8 fact and that the movant is entitled to a judgment as a matter of
9 law." At trial, PwC and E&Y will bear the burden of persuasion with
10 respect to the affirmative defense established by 15 U.S.C. § 77k(e).
11 They will be required to prove "the depreciation in value [alleged by
12 the plaintiffs] resulted from factors other than the material
13 misstatement[s] in the registration statement[s]." *Akerman*, 810 F.2d
14 at 340. The fact PwC and E&Y will bear the burden of persuasion at
15 trial shapes the parties' respective burdens at this stage in the
16 proceedings. *See Nissan Fire & Marine Ins. Co., Ltd. v. Fritz*
17 *Companies, Inc.*, 210 F.3d 1099, 1102 (9th Cir.2000) (hereinafter
18 "*Nissan Fire & Marine*"). In order for the plaintiffs to qualify for
19 summary judgment, they must demonstrate no rational juror could find
20 for the auditor defendants. *See Soremekun v. Thrifty Payless, Inc.*,
21 509 F.3d 978, 984 (9th Cir.2007). In order for PwC and E&Y to qualify
22 for summary judgment, they must prove a rational juror would be
23 compelled to find for them. *See id.* If a rational juror could find
24 for PwC and E&Y, but would not be compelled to do so, a jury issue
25 exists.
26

RULING

PwC's and E&Y's joint request for summary judgment is based, in large part, upon principles of loss causation. The term "loss causation" is associated with actions arising under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005) (hereinafter "*Dura*"). In *Dura*, the Supreme Court emphasized, "A private plaintiff who claims securities fraud must prove that the defendant's fraud caused an economic loss." *Id.* at 338, 125 S.Ct. 1627. Courts usually refer to this requirement as "loss causation." *Id.* The § 10(b) plaintiff's burden of proving "loss causation" is the "mirror image" of the § 11 defendant's burden of proving "negative causation." *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288, 2005 WL 375314, at *6 (S.D.N.Y. Feb. 17, 2005) ("the negative causation defense in Section 11 and the loss causation element in Section 10(b) are mirror images"). In *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1422-23 (9th Cir.1994) (hereinafter "*WOW*"), the Ninth Circuit drew upon the concept of loss causation in order to determine whether a § 11 defendant was entitled to summary judgment on its defense of negative causation. Thus, cases discussing loss causation provide useful guidance regarding negative causation.

The plaintiffs place great weight upon *WOW*. While *WOW*'s explanation of negative causation has never been overruled, a word of caution is in order. *WOW* was decided before *Dura*. As a result, *WOW* should be read in light of *Dura* and the cases that have interpreted

1 it. One of the more important is *Lentell v. Merrill Lynch & Co.*, 396
2 F.3d 161 (2d Cir.2005). In *Lentell*, the Second Circuit "described the
3 two requirements necessary to establish loss causation: 1) the loss
4 must be foreseeable, and 2) the loss must have been caused by the
5 materialization of the concealed risk." *In re Flag Telecom Holdings,*
6 *Ltd. Sec. Litig.*, 574 F.3d 29, 40 (2d Cir.2009) (citing *Lentell*, 396
7 F.3d at 173).

8 The first element of loss causation is foreseeability. The term
9 "foreseeability" is based, to some extent, upon the tort-law concept
10 of proximate cause. *Lentell*, 396 F.3d at 172 (citation omitted).
11 "[A] misstatement or omission is the 'proximate cause' of an
12 investment loss if the risk that caused the loss was within the zone
13 of risk *concealed* by the misrepresentations and omissions alleged by a
14 disappointed investor." *Id.* at 173 (emphasis in original) (citation
15 omitted). One of the critical considerations is whether the
16 defendant's misstatements or omissions prevented a reasonable investor
17 from perceiving the true risk of the investment. If the information
18 misstated or omitted by the defendant was such that a reasonable
19 investor would have perceived a zone of risk associated with the
20 investment had he known the true state of affairs, and if the
21 investor's loss ultimately falls within the zone of risk that was
22 hidden from him by the defendant's misstatements or omissions, then
23 the defendant's misstatements or omissions may be deemed a foreseeable
24 cause of the investor's loss. *Lentell*, 396 F.3d at 173-74 (quoting
25 *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 188 (2d Cir.2001)
26

1 (quoting *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 235 (2d
2 Cir.2000) (Jacobs, J., concurring in the mandate))).

3 The second element of loss causation is the materialization of
4 the risk. A § 10(b) plaintiff must prove the defendant's misstatement
5 or omission was revealed to the public and the public reacted
6 adversely to the revelation. *In re Williams Securities Litigation-WCG*
7 *Subclass*, 558 F.3d 1130, 1137-38 (10th Cir.2009). There are many ways
8 in which the relevant truth may emerge in the marketplace. By way of
9 illustration, a company may disclose to the public, either directly or
10 indirectly, that a previously concealed risk exists. *Id.* at 1138.
11 Again by way of illustration, a previously concealed risk may
12 materialize. *Id.*

13 PwC and E&Y question whether *WOW's* discussion of negative
14 causation is consistent with the authorities cited above. It is
15 necessary, therefore, to carefully review *WOW*. In that case, a toy
16 company offered securities for sale to the public. 35 F.3d at 1411.
17 The prospectus incorporated financial statements that had been
18 certified by the company's accountant. *Id.* at 1412-13. The
19 plaintiffs purchased securities from the company. Shortly thereafter,
20 the company began to report losses. The losses mounted to the point
21 the company decided to file for bankruptcy. *Id.* at 1411. A number of
22 investors commenced a lawsuit. They sought damages from the
23 accountant under § 11. *Id.* at 1421. In essence, they alleged the
24 accountant's determinations regarding certain sales practices allowed
25 the toy company to "'pump up' revenue figures without completing
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1 actual sales." *Id.* at 1717. The accountant asserted the defense of
2 negative causation, 15 U.S.C. § 77k(e), and filed a motion for
3 summary judgment. The district court granted the motion because the
4 toy company had not disclosed the accountant's errors to the public.
5 *Id.* at 1422. The Ninth Circuit reversed. It noted that, during the
6 six-month period between the public offering and bankruptcy, the toy
7 company had made public disclosures concerning its mounting losses.
8 *Id.* at 1422-23. The disclosures revealed steps the company had taken
9 in order to properly account for the controversial sales practices.
10 *See id.* The plaintiffs presented expert testimony indicating the
11 company's "disclosures *directly related* to the transactions for which
12 [the accountant] allegedly made erroneous accounting
13 determinations[.]" *Id.* (emphasis in original). Not only that, but
14 also the accountant acknowledged the decline in value of the company's
15 securities "corresponded precisely" to the disclosures. *Id.* The
16 Ninth Circuit held those circumstances created a genuine issue of
17 material fact. *Id.* at 1423. The circuit court explained its holding
18 more fully in a footnote:

19
20 The plaintiffs contend that [the accountant's] alleged
21 errors directly affected the market price of the debentures
22 by causing the creation of reserves to account for "false
23 sales" and, in some cases, actually enabling WOW to
24 consummate transactions it otherwise never would have
25 attempted. That contention states a direct correlation
26 between the alleged misstatements (faulty revenue
recognition) and the loss (the decline in debenture price)
and, accordingly, is sufficient to nullify [the
accountant's] "loss causation" defense on summary judgment.

1 *Id.* at 1423 n.5. The Ninth Circuit's holding regarding negative
2 causation is consistent with *Lentell* and other post-*Dura* cases. The
3 toy company's accountant allegedly erred by permitting the company to
4 recognize revenue in certain situations. The alleged error concealed
5 the risk the company might not have enough money-producing sales to
6 repay its debts. After the plaintiffs purchased their securities, but
7 before the toy company filed for bankruptcy, the company disclosed
8 mounting losses. Although the company did not admit its accountant
9 had erred, the company did reveal it had created reserves to account
10 for the controversial "sales." The revelation was directly related to
11 the accountant's alleged error. Furthermore, the revelation disclosed
12 the existence of a previously concealed risk, and the investors
13 produced evidence indicating the marketplace reacted negatively to the
14 company's disclosures. Thus, a jury issue existed with respect to
15 whether the investors suffered a foreseeable loss.
16

17 Read together, *WOW*, *Dura*, and *Lentell* clarify the law governing
18 PwC's and E&Y's affirmative defense of negative causation. At trial,
19 they will be required to prove the plaintiffs' alleged losses were
20 caused by a factor or factors other than the market's adverse reaction
21 to the revelation of a risk they allegedly concealed. Since PwC and
22 E&Y will bear the burden of persuasion at trial, they are entitled to
23 summary judgment only if a rational jury would be compelled to find
24 for them on their affirmative defense. See *Soremekun*, 509 F.3d at
25 984. More precisely, they are entitled to summary judgment only if a
26 rational jury would be compelled to find the plaintiffs' alleged

1 losses were caused by a factor or factors other than the market's
2 adverse reaction to the revelation of a risk they allegedly concealed.
3 The plaintiffs do not bear the burden of persuasion on negative
4 causation. In order to obtain summary judgment on the issue, they
5 must show that a rational jury would be unable to find for PwC and
6 E&Y. *See Nissan Fire & Marine*, 210 F.3d at 1102. More precisely,
7 they must show that a rational jury would be unable to find their
8 alleged losses were caused by a factor or factors other than the
9 market's adverse reaction to the revelation of a risk previously
10 concealed by PwC and/or E&Y. With these principles in mind, it is
11 appropriate to turn to the evidence presented by the parties.

12 PwC sold a tax shelter to Met during FY 1999. The shelter was
13 named the "Foreign Leveraged Investment Program" ("FLIP"). It
14 consisted of series of investments in a Swiss bank and other foreign
15 corporations. PwC indicated the FLIP would result in an \$80 million
16 loss that would generate \$28 million in tax savings. PwC issued a
17 written opinion indicating, on a "more likely than not" basis, Met
18 would be permitted to retain the tax savings generated by the FLIP in
19 the event the Internal Revenue Service ("IRS") challenged the
20 transaction. The FLIP transaction figured in Met's FY 2000 and 2001
21 financial statements. PwC audited the FY 2000 financial statement.
22 E&Y audited the FY 2001 financial statement. The plaintiffs allege
23 PwC's and E&Y's accounting treatment of the FLIP transaction violated
24 generally accepted accounting principles ("GAAP") and enabled Met to
25 overstate its shareholders' equity during both fiscal years. As it
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1 turned out, the IRS challenged the FLIP transaction. A newspaper
2 published articles on the 16th and 23rd of August, 2003, disclosing
3 the IRS's action. During that month, the price of Met's publicly-
4 traded securities dropped dramatically, rebounded some, and began to
5 drop again.

6 The evidence summarized above is sufficient to defeat PwC's and
7 E&Y's motion for summary judgment with respect to negative causation.
8 The plaintiffs allege PwC's and E&Y's accounting treatment of the FLIP
9 transaction enabled Met to overstate its stockholders' equity in both
10 its FY 2000 and FY 2001 financial statements. The overstatement
11 significantly altered the total mix of information that was available
12 to potential investors. *See AUSA Life Ins. Co. v. Ernst & Young*, 206
13 F.3d 202, 235 (2d Cir.2000) (Jacobs, J., concurring in the mandate).
14 A person who was evaluating the risk Met would default on its debts
15 would have viewed the company's debt securities more cautiously had he
16 known the stockholders' equity was significantly overstated. So, too,
17 a person who was attempting to predict the future performance of Met's
18 equity securities. It follows PwC's and E&Y's alleged accounting
19 error concerning the FLIP transaction concealed the true risks that
20 investors faced.
21

22 During August of 2003, information leaked into the marketplace
23 that allegedly indicated the risks associated with Met's securities
24 were greater than investors had realized. A Spokane newspaper
25 published articles on the 16th and 23rd of August indicating the IRS
26 was challenging the FLIP transaction. It is true, as PwC and E&Y

1 observe, that the articles did not disclose the existence of PwC's and
2 E&Y's alleged accounting errors. However, a "disclosure need not
3 precisely mirror the earlier misrepresentation[.]" *In re Williams*
4 *Securities Litigation-WCG Subclass*, 558 F.3d at 1140. It is
5 sufficient that the disclosure "relate[s] back to the
6 misrepresentation and not to some other negative information about the
7 company[.]" *Id.*; see also *Metzler Inv. GMBH v. Corinthian Colleges,*
8 *Inc.*, 540 F.3d 1063 (9th Cir.2008) ("Plaintiffs adequately pled loss
9 causation in *Daou* because their complaint alleged that the market
10 learned of and reacted to this fraud, as opposed to merely reacting to
11 reports of the defendant's poor financial health generally." (citing
12 *In re Daou Systems, Inc.*, 411 F.3d at 1026)).

13 The plaintiffs allege the marketplace reacted adversely to the
14 disclosure of the IRS's response to the FLIP transaction. There is
15 evidence in the record supporting their allegation. For example, the
16 share price of Met's publicly-traded securities declined after the
17 newspaper articles appeared. PwC and E&Y dispute the plaintiffs'
18 assessment of the evidence. As they point out, other negative
19 information concerning Met and Summit was making its way into the
20 marketplace. Given the existence of the information cited by PwC and
21 E&Y, a rational juror could find the share price decline that began
22 during August of 2003 was a result of factors other than the
23 revelation of the IRS's decision to challenge the FLIP transaction.
24 That is to say, a rational juror could find for PwC and E&Y on the
25 issue of negative causation; which means the plaintiffs are not
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1 entitled to summary judgment. Nevertheless, a rational juror would
2 not be compelled to find for PwC and E&Y. A rational juror could find
3 the disclosure of the IRS's decision was a substantial factor in the
4 August decline in the share price of Met's publicly-traded securities;
5 which means PwC and E&Y are not entitled to summary judgment either.

6 The preceding ruling does not discuss, much less resolve, all of
7 the plaintiffs' theories of loss causation. There are two reasons why
8 the Court declines to say more. To begin with, it is unnecessary.
9 The Court has identified genuine issues of material fact that preclude
10 summary judgment; that is enough to adjudicate the parties' motions.
11 Furthermore, the plaintiffs' "materialization of the risk" theory
12 raises issues that require further analysis. The plaintiffs clarified
13 this theory at oral argument. They submit the errors PwC and E&Y
14 allegedly committed while conducting the FY 2000 and FY 2001 audits
15 created a risk the Securities and Exchange Commission ("SEC") would be
16 unwilling to approve new registration statements submitted by Met and
17 Summit. According to the plaintiffs, the risk materialized when
18 Summit allegedly was unable to satisfy the concerns the SEC expressed
19 in its 2002 and 2003 "comment" letters. The problem with the
20 plaintiff's "materialization of the risk" theory is this: It is
21 questionable whether the risk of delay by the SEC "was within the zone
22 of risk *concealed* by the misrepresentations and omissions alleged by
23 [the plaintiffs]." *Lentell*, 396 F.3d at 173 (emphasis in original).
24 It would be one thing if there was evidence indicating PwC and E&Y
25 made misrepresentations regarding the SEC's review of future
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1 registration statements. Such misrepresentations arguably could have
2 deceived investors into discounting the risk of SEC disapproval.
3 However, there is no evidence PwC and E&Y overstated the likelihood
4 the SEC would approve future registrations statements or understated
5 the financial problems Met and Summit would experience if the SEC
6 refused to do so. Perhaps the plaintiffs can maintain their
7 materialization theory without such evidence; though the Court is
8 skeptical. In any event, since it is unnecessary to resolve the issue
9 in order to adjudicate the parties' cross-motions for summary
10 judgment, the Court declines to do so.

11 **IT IS HEREBY ORDERED:**

12 1. The plaintiffs' motion for partial summary judgment (**Ct. Rec.**
13 **771**) is **denied**.

14 2. PricewaterhouseCoopers' and Ernst & Young's joint motion for
15 summary judgment (**Ct. Rec. 751**) is **denied**.

16 **IT IS SO ORDERED.** The District Court Executive is hereby
17 directed to enter this order and furnish copies to counsel.

18 **DATED** this 22nd day of January, 2010.

19
20 s/ Fred Van Sickle
21 Fred Van Sickle
22 Senior United States District Judge
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